CALIFORNIA CASUALTY

PRIVATE PASSENGER AUTO

COVID-19 EXPLANATORY MEMORANDUM

California Casualty is an insurance company domiciled in California that has been providing personal lines insurance to affinity group members (educators, police officers, firefighters, highway patrol officers and nurses) for over 100 years.

California Casualty is unique from other insurance companies in four very significant ways which makes it essential that we be very cautious in analyzing the impact of short-term changes.

1. <u>Customer Base</u>: California Casualty has a very unique customer base that is different from other companies. Most of our customers are Firefighters, Law Enforcement Officers, Nurses, Paramedics, Doctors and Educators. These people provide essential services to their communities and as such, have exhibited very different driving patterns during this period compared to the average American. While most companies have a customer base that has sheltered in place and reduced their driving during this period, many of our policyholders continue to commute to work every single day because of the job requirements.
2. <u>Reciprocal Exchange</u>: The California Casualty Indemnity Exchange is a reciprocal exchange, an unincorporated entity owned by its **policyholders**. As such, any profits from operations flow into surplus and this surplus is solely owned by the **policyholders**. This is quite different from stock companies where profits accrue to the benefit of the shareholder-owners. As a reciprocal, we don't have ready access to capital markets to replenish surplus, so we have always managed the operation in the best <u>long-term</u> interests of our policyholder-owners.
3. <u>Annual Policies</u>: California Casualty only writes annual Auto policies whereas most other companies only write 6-month policies. A 12-month policy gives a customer rate protection for an entire year whereas with a 6-month policy, the rate can be increased in half that time. An insurance company offering a 6-month policy can quickly raise rates if a customer has an accident, traffic tickets, or to recoup any COVID-19 refund that was given prematurely. Our 12-month policy does not allow for such quick rate action which is another reason why we must take a longer-term view regarding any change in driving habits resulting from COVID-19. While offering the benefit of 12-month rate protection, we have to be careful not to overreact to

short-term changes in driving patterns. This long term approach allows us to fully and accurately see how accident rates and claim costs ultimately are affected.

4. California Exposure: California Casualty has 50% of its book in California (a far greater percentage than most national companies) which makes its surplus far more vulnerable than other companies to the "localized" catastrophes we've seen in recent years. We've demonstrated the ability to manage these by taking a long-term view.

No one knows the ultimate impact of COVID-19. In the short-run, accident frequency has been lower than normal, but it is difficult to tell how long it will last.   Anxiety around taking crowded flights and a reluctance to take public transportation may actually result in more driving and a rise in accident frequency during the second half of the year. At this point, it is very uncertain what the ultimate reduction in claim costs might be and that is a critical consideration for a company that writes 12-month policies.

While there is uncertainty around the ultimate impact on claim frequency, there are many other forces putting upward pressure on claim severity.   For example:

- With fewer cars on the road, driving speeds have increased resulting in more severe accidents when they do occur. There is evidence that this is already happening. Several studies have shown that the drop in the rate of driving fatalities has not kept pace with the drop in overall claim frequency. With a rise in the overall fatality rate as a result of the higher rates of speed, it stands to reason that there would also be an increase in the number of accidents that result in a significant injury but not a fatality. These are some of the most traumatic and costly accidents.
- There has been an increase in the number of commercial vehicles on the road as a percentage of total vehicles. With the increase in on-line shopping due to the shelter orders, there are more delivery trucks than ever. Given the rapid escalation in demand, many of these are driven by less experienced drivers. All this increases the likelihood of a collision between a larger commercial vehicle and a private passenger automobile further increasing overall severity.
- Medical costs will continue to rise and possibly at an accelerated rate as people that weren't being treated for recurring health problems during this period when the focus

was on the Coronavirus compete for the same scarce medical resources that are needed to treat automobile injuries.

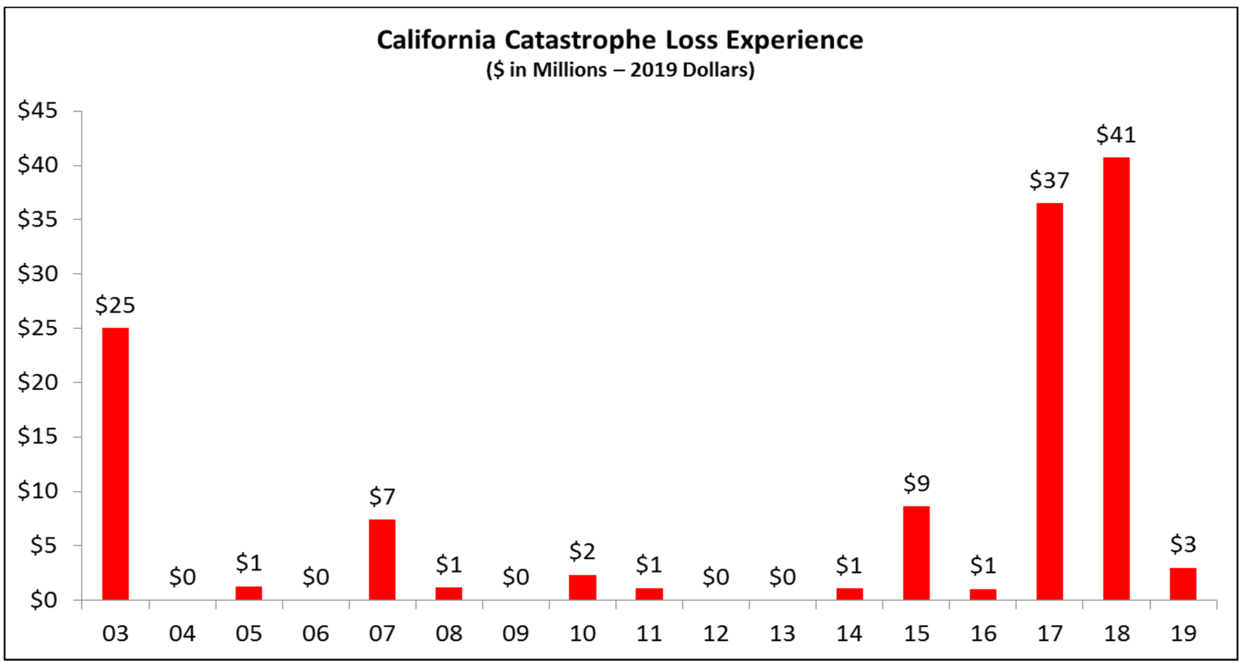
- Legal costs will likely rise as law firms try to recoup what they lost during this period.
- With factories that typically produce auto parts being transitioned to making masks and ventilators, the cost and availability of replacement auto parts is unknown.
- Rental car companies will have to completely sterilize the cars before they send them back out which obviously adds cost.
- With forestry being deemed a non-essential business, dead trees are not being cleaned out now which could result in catastrophic fires later in the year. Along with the homes, many autos are destroyed in these fires.

The upward pressure on severity in the second half of the year could easily wipe out any temporary frequency reduction. It is premature to know the ultimate impact on pure premium. By writing only 12-month policies, it is critical to take a long-term view and cautiously evaluate the impact of short-term changes. There are many ups and downs in this business and it is critical for us to always take the long-term view of building financial strength so that nothing is done, in any way, to jeopardize our ability to be there when our policyholder-owners really need us. Above all else, we have to have the financial strength to pay claims when the need arises so that policyholders can put their lives back together following traumatic events. That makes the long-term view absolutely essential.

As a company domiciled in California with a significant portion of its book here, we are impacted more severely by catastrophes in this state than are national carriers. This is another reason why it is essential to take a long-term, balanced view of building financial strength in a volatile environment. In years where significant catastrophes occur, insurance companies do not collect additional premium to pay for those losses. On the flip side, if refunds and rate reductions are required in years where favorable experience develops, all balance gets lost. Lack of balance makes it is very difficult to build the requisite financial strength that policyholders must rely on for financial protection of their major assets. That is the most important reason they buy an insurance policy.

As mentioned earlier, California Casualty has around 50% of its book in California (a far greater percentage than national companies) making it far more susceptible to catastrophes in California. It is because of our long-term view and the balance sheet strength that we have maintained, that we have always been able to take care of all our policyholders through all the California specific volatility of the past. Whether it was following the Northridge earthquake in 1994 or any of the devastating fires that have occurred since, while many other companies have withdrawn from the market or dramatically restricted writings, California Casualty has remained consistent in its long-term view and continued to serve its affinity groups.

The following chart highlights some of the problems of taking a short-term view of building financial strength. Following a run of 6 years with below average catastrophe experience, California Casualty was required to take a substantial rate reduction in 2014. In three of the next four years following the rate reduction, California had some of the most devastating fires in its history. Losses in 2017 and 2018 were almost 5 times normal levels. Naturally, this succession of events depleted surplus. Since we have always taken the long-term view of building financial strength, we were able to withstand these catastrophes and still retain an extremely strong balance sheet. However, it shows how important it is to take the long-term view when building financial strength.



While catastrophe losses averaged about $3.3M in the 12 years from 2003-2014, they jumped to an average of $22M over the next 4 years and $39M in 2017-2018 alone. The catastrophic fires in California during 2017 and 2018 were the principal reason that the company's surplus declined by $81M during that period. Reacting to a short period with little or no catastrophe losses can create a regulatory one-way street and threaten insurer solvency when actual catastrophe losses have averaged about $8M over an extended period.   Managing volatility requires a long-term view.

We have a similar situation with the recent short-term reduction in miles driven. Reacting to a short-term drop in frequency with an unknown severity component and a potential rise in claim frequency during the second half of the year, could certainly impede an insurer's ability to build financial strength. It is crucial that we continue the long-term view and not overreact to the short-term drop in miles driven. This assures that we can rebuild the surplus lost the last few years to protect our policyholder-owners going forward

California Casualty implemented a unique plan to take care of our policyholders during this period of extreme uncertainty dictated by the COVID-19 pandemic. We communicated individually with each of our policyholders to help tailor unique solutions for them without compromising our number one responsibility of remaining financially strong. Ultimately, our plan will deliver over $7.5M in savings to our policyholders. The plan had four different components:

1. <u>Mileage Adjustments</u>: One of the fundamental concepts of a successful long-term program is the ability to match price with exposure. Since many of our policyholders are providing essential services, they are continuing to commute to work (albeit in lighter traffic) and their mileage driven hasn't materially changed. Those that have experienced a temporary drop in mileage were encouraged to call into Customer Service so that we can work with them individually to make sure that the price they are paying adequately reflects their annual exposure. We communicated with all of our insureds to make them aware of this option. This approach has the additional customer service benefit of allowing a trained representative to essentially perform a full policy review to make sure that all the coverages and limits are appropriate.
2. <u>Payment Skip</u>: We introduced an expanded program where any customer can automatically defer any two consecutive months of premium payments in their entirety. This is a significant benefit to any insured that is struggling. Instead of waiving a small portion of the premium, we are allowing them to defer 100% of it for two months. This provides immediate substantial financial relief for policyholders.
3. <u>Deductible Waivers</u>: We made the decision to waive up to $250 of the collision deductible in the event one of our policyholders had a driving related accident during the period. Many of our policyholders are providing essential services to the general public and if they are involved in an accident, the $250 they don't have to pay to get their car repaired will be significant.

4. California Auto Filing: We had a filing pending before the DOI for a 4.5% rate increase that was fully justified based on our experience and in the final stages of the approval process. Given the anticipated drop in prospective claim frequency, we made the decision to withdraw that filing.

Because of the uniqueness of California Casualty as described above, our approach may differ from that of other companies, but ultimately delivers a significant overall package of changes to our policyholders. Those that were actually driving less during this period received premium credits averaging 16.8%. Additionally, to reflect the fact that many of our policyholders are providing essential services that required them to continue driving, we withdrew our California filing so that all policyholders would benefit. Rolling back the intended rates effectively saves $7.0M for our California policyholders which amounts to about $92 per policyholder. Overall, the changes amount to a savings of $7.5M.